

# Senior Consultant

The Voice of the Investment Management Consultant

## Hedge Fund Practices of Brokers Come under Closer Scrutiny

*Victor L. Zimmermann, Jr., Partner, Curtis, Mallet-Prevost, Colt & Mosle LLP*

The recent decision by the NASD to focus on hedge fund sales practices means that those who currently sell hedge funds and funds-of-funds are now going to have to closely examine their sales techniques and undertake extensive due diligence in the future. In particular, the NASD has advised that oral presentations and promotional material be balanced with suitably worded warnings about the nature of hedge fund investing.

With the recent release of the report, "Implications of the Growth of Hedge Funds" by the staff of the U.S. Securities and Exchange Commission ("SEC"), it appears that new regulation is just around the corner. However, what has been somewhat overlooked is the effort already underway by self-regulatory organizations, such as the National Association of Securities Dealers (NASD), to increase their regulatory focus on member firms that sell hedge funds or provide services to them. Earlier this year, the NASD put its member firms on notice that it will look to a longstanding NASD rule to regulate the hedge fund sales practices of broker-dealers, both those which serve as prime brokers and offer capital introduction services to the qualified or accredited investor, as well as those brokers who market hedge fund investments to the retail investor.

Most investment funds in the U.S. are considered "investment companies" subject to registration under the Investment Company Act of 1940 ("Investment Company Act") and offer shares pursuant to registration statements filed with the SEC under the Securities Act of 1933 ("the 1933 Act").

The regulations that apply to sales and offers of securities of investment funds registered under the Investment Company Act provide investors with various protections and disclosures. These include, among other things, the requirement of a certain minimum degree of liquidity and of disclosure of information about the fund's management, holdings,

expenses and fees; the requirement that fund shares be redeemable; a maximum limit on how much of any single investment can be purchased and a limit on the use of leverage; and protection against conflicts of interest and unfairness in pricing shares of funds. The regulations that apply to sales and offerings of securities of funds registered under the 1933 Act provide the investor with further protection in requiring disclosure of the risks and nature of the offered securities.

Most hedge funds, as opposed to other types of investment funds, are investment companies not registered pursuant to certain exemptions under the Investment Company Act. Moreover, the securities offered by hedge funds, mainly in the form of limited partnership interests, are exempt from registration under the 1933 Act so long as the fund does not make a public offering of its securities.

Since neither the hedge fund nor the limited partnership interests are registered, the safeguards for investors by virtue of registration under the Investment Company Act and the 1933 Act are not present. As a result, U.S. law provides that unregistered hedge fund interests may only be offered to certain "qualified investors" who meet the financial tests set forth in the exemptions of the Investment Company Act and the 1933 Act.

As discussed below, the prime brokers have become more involved in sourcing capital for unregistered hedge funds to qualified accredited investors, where limited partnership interests are privately placed. Broker-dealers who market to the retail investor have also become more involved in hedge fund products, as more and more funds-of-funds have registered their securities under the 1933 Act. Although these funds typically invest only in underlying hedge funds open to accredited investors, the funds-of-funds themselves are registering their securities under the 1933 Act so as to lower investment minimums and open themselves to the retail investor. While the unregistered hedge funds may have minimum investment restrictions of

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\$1 million, a registered fund-of-funds may have minimums as low as \$25,000.

While the prime brokerage business has become more substantial, it has also become increasingly competitive. As it has evolved, prime brokers have begun to offer capital introduction services to their hedge fund clients as an additional service in an attempt to obtain their business. With the plethora of new funds over the past few years and with tight global capital markets, new funds as well as old ones have successfully utilized introductions by their prime brokers to source new capital.

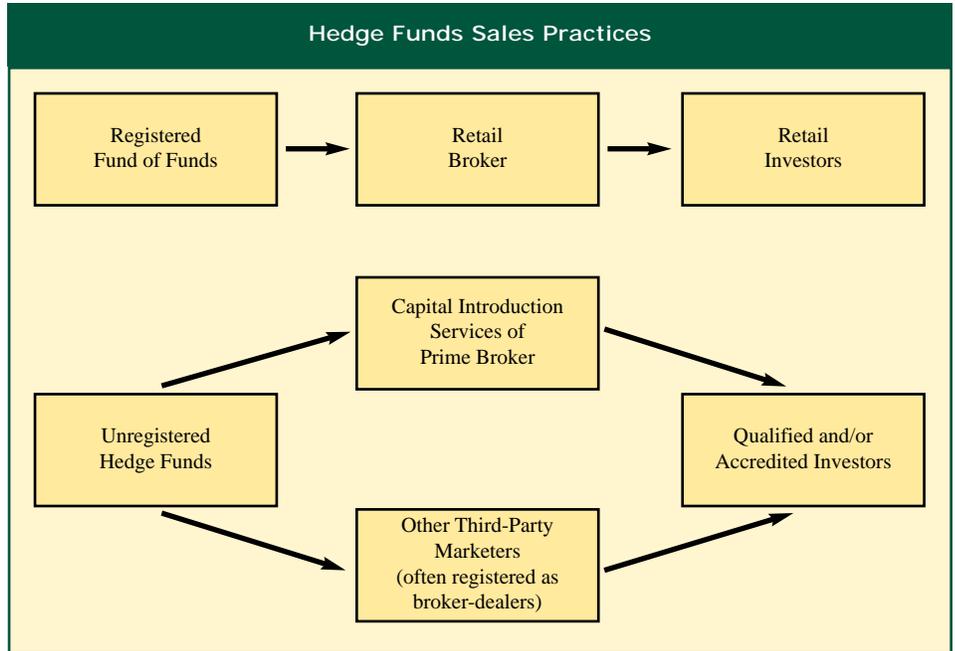
### The Prime Broker

Prime brokers are brokers who help to minimize operational and accounting-related issues and to curb costs through consolidated financing, while still providing their hedge fund clients with the benefits of executing with any number of brokers. The prime broker clears the trade, acts as custodian for the securities, provides margin financing, lends stock to cover short sales, and provides cash and position reports and technology.

Funds that trade internationally require prime brokers who can clear and settle trades not only in its own time zone but internationally. Prime brokers for international funds must also be able to borrow securities in every market and provide multi-currency reports, valuing portfolios in local currencies and in a base currency. Since the prime broker often has an international reach, it is a natural resource for the funds to utilize to introduce their products to an international investor base.

The prime brokers have traditionally offered these capital introduction services at no additional cost. They sometimes arrange direct introductions, but more often, arrange for hedge fund managers to speak at the various conferences they offer where high net worth clients of the prime brokers are likely to be in attendance.

For many reasons, the prime brokers, in making these capital introductions, have generally not placed great emphasis on making sure that a particular hedge fund investment is suitable for each client to whom it is shown or introduced. The prime brokers have generally viewed their role in this process as not rising to the level of actually making a recommendation to invest in a specific security offered by the



hedge fund, considering the limited nature of their services and the lack of any direct compensation.

### Other Broker-Dealers

As noted above, broker-dealers who cater to a retail clientele have only recently become more involved in hedge fund offerings since some funds-of-funds have begun to register under the 1933 Act and the Investment Company Act in an effort to reach the retail investor. Although these funds-of-funds are registered under the Investment Company Act and offer securities registered under the 1933 Act, they pose many of the same risks to investors as the unregistered funds, since the underlying investments are in unregistered hedge funds. The NASD's particular concern is that the registered funds-of-funds are offered to investors who have far less financial means than investors eligible to invest directly in the underlying funds.

### NASD Notice to Members

A recent NASD Notice to Members has now made it clear that the capital introduction services offered by prime brokers for unregistered funds and the offering of registered fund-of-funds interests by broker-dealers to retail

investors must comply with the NASD's rule regarding suitability. The NASD has served notice to the prime brokerage community that their capital introduction services for the unregistered funds offered to qualified and accredited investors, which they believed were not recommendations subject to the NASD's suitability rule, can constitute a recommendation by the prime broker as to that particular investment; and when making a recommendation, the prime broker must ensure that the recommendation is suitable for the particular client, notwithstanding the fact that the client is a "qualified investor."

Suitability means that the member firm must have both a reasonable basis for believing that the product is suitable for any investor ("reasonable-basis suitability") and must determine that its recommendation to invest in a hedge fund or fund of hedge funds is suitable for the particular investor ("customer-specific suitability").

Member firms satisfy the reasonable-basis suitability by conducting due diligence with respect to the hedge fund or the underlying funds in the case of a fund-of-funds. Due diligence would entail an investigation into the background of the hedge fund manager, reviewing the offering memorandum, reviewing the subscription agreements, examining



references and the relative performance of the fund.

### NASD Rule 2310 – The Suitability Rule

The suitability rule, NASD Rule 2310, addresses the NASD's customer-specific suitability requirement. This rule requires that a broker-dealer must make sure that if it makes a recommendation on a security, that the security is suitable for a particular investor. The NASD's suitability requirement is meant to promote high standards of professional conduct and ethical sales practices. The suitability requirement applies to any sale of a security by a NASD member firm.

#### Factors That Determine Suitability

The suitability rule requires that a broker-dealer have reasonable grounds for believing that his recommendation to an investor to purchase, sell or exchange a security must be suitable to the investor, based on any facts disclosed by the investor about his financial situation, needs and other security holdings. NASD's Notice to Members 03-07 (published in February 2003) clarifies that, while some firms rely heavily on an investor's accredited status as the sole criterion for satisfying the suitability requirement, the investor's level of assets does not alone make an investment in a fund suitable to him.

The suitability rule requires that before a broker-dealer recommends an investment (other than one limited to money market mutual funds) to a non-institutional investor (meaning a natural person), he must make reasonable effort to obtain and must examine the following information: (1) the customer's financial status, (2) the customer's tax status, (3) the customer's investment objectives and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

In recommending an investment to an institutional investor, the most important factors that a broker-dealer must consider in order to ascertain whether the investment is suitable to

the investor are the investor's ability to independently evaluate investment risk and the degree to which the investor exercises independent judgment in assessing the recommendation of the broker-dealer.

The Notice to Members 03-07 states that the broker-dealer must have internal controls to assure that it follows the suitability rule. Broker-dealers must have written procedures for supervisors to assure that the suitability requirements are complied with and that information gathered regarding the suitability of investors is reviewed.

#### What Constitutes A Recommendation?

Notice to Members 96-60 (published in September 1996) states that a broker-dealer's

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suitability obligation only applies when he makes a recommendation. Therefore, there is no suitability obligation when a broker-dealer acts only as an order-taker for investors who effect transactions on their own initiative without a recommendation.

Notice to Members 01-23, (published in April 2001) states that the suitability rule applies to all recommendations made by broker-dealers. Whether any communication constitutes a recommendation is a "facts and circumstances" inquiry that demands an analysis of the "content, context and presentation" of the communication. An important element in considering the facts and circumstances is whether the communication would be viewed by the investor as a "call to action." The more individually the communication is adapted to a specific investor or to a specific group of

investors, the more likely it is that the communication would be seen as a recommendation. A suitability obligation cannot be discharged by a broker-dealer by means of a disclaimer if a particular communication would otherwise be seen as a recommendation. When a broker-dealer provides unrequested information that is not of a generalized or administrative nature to an investor, it may possibly be viewed as a recommendation considering its content, context and presentation, even when it does not suggest a purchase, sale, or exchange of a security.

#### Other NASD Sales Practice Concerns

In addition to its concerns regarding suitability, NASD's recent Notice to Members also cautions members regarding their obligations concerning sales practices when promoting hedge fund investments. Sales material and oral presentations that promote hedge funds or funds of hedge funds raise particular concerns. The NASD asserts that its members may not claim that hedge funds offer superior professional management with more investment flexibility, protection against declining markets and better returns due to the imposition of performance fees (e.g., fees charged by the hedge fund adviser based on the fund's investment performance), unless these statements are fair, accurate and

without exaggeration. In addition, the Notice to Members states that members must balance sales material or oral presentations that promote the advantages of hedge fund investing with full disclosure of the risks that hedge funds present, including, as applicable, the fact that hedge funds (or funds of hedge funds):

- often engage in leveraging and other speculative investment practices that may increase the risk of investment loss;
- can be highly illiquid;
- are not required to provide periodic pricing or valuation information to investors;
- may involve complex tax structures and delays in distributing important tax information;
- are not subject to the same regulatory requirements as mutual funds; and
- often charge high fees.

## Conclusion

The recent NASD Notice to Members, which has not been widely followed, may have more effect than some of the additional legislation and regulation currently under discussion. Although the NASD does not have jurisdiction over the hedge funds or funds-of-funds themselves, its edict regarding sales practices will require those who sell hedge funds and funds-of-funds to review and modify their existing sales practices and undertake more due diligence when promoting these investments. ■

## About the Author

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## Notes

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